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SUBJECT: DPRK ECONOMY: CHINESE EXPERTS FORESEE ECONOMIC

REFORMS, BUT DOUBT ANY CHANGE IN ROLE OF MILITARY

Classified By: EconMinCouns Kurt Tong, for Reasons 1.4 (b,d)

SUMMARY

1. (SBU) A January 18-19 academic conference in Beijing explored the potential for North Korea to change its "military first" security policy in order to realize more meaningful economic reform, faster economic growth and an increase in international aid. The American organizers of the event worked hard to highlight the likely improvements in North Korean economic performance resulting from a "bold switchover" in North Korea's security stance, while also emphasizing the potential for increased inflows of development assistance from overseas in such a situation. Chinese and South Korean experts participating in the event, however, tended to discount the incentives for change in North Korea's security stance. At the same time, they also doubted the potency of the disincentives to the DPRK maintaining its current hostile stance to the outside world.

2. (C) While there was significant diversity of opinion among the Chinese think-tank experts assembled at the conference, the majority seemed to believe that it was most likely for North Korea to pursue a certain pace and degree of economic reform, while continuing to avoid risky changes in internal political alignment. All the Chinese experts, however, agreed that North Korea would continue to try to strengthen its economic relationship with China, and many believed that North Korea will attempt to mimic China's economic reform path -- although the DPRK might not necessarily succeed. End summary.

NBR CONFERENCE TACKLES "BIG PICTURE" REFORM POSSIBILITIES

2. (C) Embassy Seoul EconMinCouns was recently invited to participate in a closed-door, off-the-record academic conference in Beijing focused on identifying the economic benefits to North Korea and the region of a "bold switchover" in North Korea's security stance. The "bold switchover," as

defined by conference organizer Nick Eberstadt of the American Enterprise Institute, refers to a curtailing of the DPRK's "military first" policy and substantial downsizing of the North Korean military -- including, by definition, de-nuclearization. The event, which was convened and funded by the Seattle-based National Bureau of Asian Research (NBR) with assistance from China's State Council Development Research Center (DRC) and the PLA-affiliated Chinese Foundation for International and Strategic Studies (CFISS), was somewhat unique (as Track II events go) for the variety of opinion presented by the Chinese experts in attendance, as well as the frankness of their commentary. This message was coordinated with Embassy Beijing.

DPRK CAUGHT IN A TRAP OF ITS OWN DESIGN

13. (C) Keynote speaker Zhao Huji of the Central Party School kicked the proceedings off on a pessimistic note by explaining the chicken-and-egg dilemma of North Korea's three "structural crises:" in economics; political legitimacy; and military affairs. Zhao persuasively argued that the DPRK's economic reforms had reached an impasse; without broader opening to the outside, accelerated economic progress could not be anticipated. However, Zhao asserted that the North's chronic food shortage and limited economic reforms that have taken place to date have already established a "second economy" throughout the country, which constitutes a potential political challenge to North Korea's leadership. Meanwhile, on the military and security front, the DPRK is trapped in a "military first" policy that exaggerates external threats to the country in order to compensate for the absence of a strong philosophical underpinning for the government.

14. (C) Thus, Zhao concluded, a "bold switchover" is difficult, given that North Korea is also loathe to rely

entirely upon China or Russia for its security. Zhao believes the July 2002 economic reforms have already had a large impact on the North Korean economy, but he forecast ultimate failure for the reforms given the inability of the North Korean regime to contain the macroeconomic instabilities generated by the reforms. In short, Zhao said, North Korea needs a "bold switchover" to succeed in economic reform, but the leadership cannot risk such a fundamental realignment due to its own lack of political legitimacy.

ECONOMIC BENEFITS FROM A CHANGE IN DPRK SECURITY STANCE

15. (SBU) Nick Eberstadt followed with a more positive spin on the potential for change in the North. Like Zhao, Eberstadt concurred that the "military first" policy, the DPRK's chosen approach to state survival, actually precludes long-term success in state survival. Taking a positive tack, however, he presented an econometric analysis based on data from other transition economies to loosely quantify the potential for economic growth if North Korea were to relinquish its current security policy stance. Such a change, Eberstadt said, would free significant capital and labor resources for use in more productive ways. Eberstadt also noted that considerable Western aid would be made available to the North if it were to undertake a "bold switchover," even absent any fundamental realignment of North Korea's centrally-planned economic system.

16. (C) In commentary on Eberstadt's paper, Zang Hyoungsoo of South Korea's Hanyang University questioned how much incremental foreign aid would really be forthcoming for North Korea after a change in its security stance. He also noted that the labor contribution benefits of a "bold switchover" might be exaggerated, given that the North Korean military is already an important participant in the economy; Zang foresaw greater benefits from reallocation of capital resources. Piao Jianyi of the Chinese Academy of Social Sciences chimed in with doubts about the earnestness of North Korea's economic reform efforts, or any real interest in changing the

"military first" policy. Piao explained that that he is convinced the DPRK's over-riding goal is to re-establish aid relationships so that it can return to the relative stability it enjoyed in the 1980's, under the umbrella of Soviet assistance.

17. (C) Hu Angang of Tsinghua University countered that North Korea is very interested in learning from China, as well as simply garnering Chinese economic aid and deepening trade and investment relations with China. This, Hu said, is why Kim Jong-il had chosen to visit China just as the Chinese government was in the midst of writing its next Five-Year Plan (China's primary instrument for medium-term fiscal policy planning). Hu then proceeded to outline the reasons for the success of China's transition development model: 1) macroeconomic stability; 2) political stability based around Deng Xiaoping's determination to catch up with the outside world; 3) gradualism, starting with agricultural sector reform; and 4) external opening and a stable relationship with the United States. Hu suggested that the United States should invite Kim Jong-il to the United States, as it did Deng Xiaoping in the 1970's. China, meanwhile, should open its markets wider to North Korea, and accelerate investment in North Korean infrastructure, human resources and agricultural reform programs, Hu said.

18. (SBU) Yoon Deok-ryong of the Korean Institute for International Economic Policy (KIEP) followed with a presentation outlining the details of South Korean economic cooperation with North Korea, concluding that "peace" between North and South will result in substantial economic benefits for both sides. In the North, economic reform and opening will accelerate growth, while in the South, "peace" will improve the ROK's credit rating and provide new opportunities for profitable investment and trade with North Korea and Northeast China. Yoon asserted that ROK government investments in economic cooperation with North Korea in the current timeframe will not only help hasten the arrival of

this economic "peace dividend," but also lower ultimate reunification costs in the long-term.

19. (C) Commenting on Yoon's presentation, Marcus Noland of the Institute for International Economics downplayed the significance of North Korea's July 2002 economic reforms, describing them as nothing more than a coping strategy to ratify, legalize and thereby control ongoing marketization. Noland also explained his view that official assistance to North Korea in the current situation could actually inhibit further economic reform, rather than accelerate it. Cheng Yujie of the China Institute of Contemporary International Relations (CICIR) chimed in with a somewhat superficial presentation about the need for caution and gradualism in approaches to North Korea, due to the unlikelihood that the DPRK leadership would buy into sudden change. Given that the military is already integrated into the DPRK economy, rapid marketization could destabilize the government through both challenges to ideology as well as confusion among political and economic stakeholders.

110. (SBU) Masahiro Kawai of the Asian Development Bank and former World Bank official Bruce Babson wrapped up the first day's proceedings with presentations on the potential for post-"bold switchover" economic assistance from Japan and the international financial institutions (IFI's). Kawai noted that de-nuclearization and resolution of the abductions issue were mandatory preconditions for extensive Japanese assistance. However, in the context of such changes, and normalization of Japan-DPRK ties, Kawai foresaw that a consequent Japanese aid package to North Korea could be on roughly the same scale (plus inflation) as that provided to the Republic of Korea at the time of Japan-ROK normalization in 1965.

111. (SBU) In outlining the process for new members to join the International Monetary Fund and World Bank, Babson perhaps unintentionally ended up highlighting the difficulties that North Korea would face in accessing aid

from the IFI's. The DPRK would need to first accept the IMF's transparency and accounting norms, Babson said. Following that, the first stages of IFI assistance would likely center on technical assistance, and establishment of international donor coordination systems, rather than large immediate infrastructure investments. Chinese participants in the conference reacted with some dismay to Babson's presentation, noting that the North Koreans would perceive all this as a threat to their sovereignty, without accompanying benefits. Kawai of the Asian Development Bank tried to soften the blow by suggesting that the ADB would likely be more generous than the World Bank, and not require IMF membership first -- points which Babson in turn found distressing.

BENEFITS FOR NORTHEAST CHINA?

¶12. (C) For the concluding session on Day Two, Li Dunqiu of the State Council Development Research Center began the proceedings with a well-researched illustration of the rapidly deepening economic ties between North Korea and Northeast China. Li foresaw large benefits for Northeast China stemming from economic reform and opening in North Korea, with the best case scenario being open borders between North and South Korea, which "would forcefully propel the economic development of China's northeast." Foreign investors would find the Northeast China region much more attractive if military tensions in the region were eased, Li concluded.

¶13. (C) Commenting on Li's presentation, contrarian Piao Jianyi of CASS asserted that a "bold switchover" in North Korea could also end up hurting Northeast China, via resulting political instability and refugee flows. David Dollar of the World Bank's Beijing Office concurred with Li in identifying the benefits for Northeast China of changes in North Korea, although he cautioned that it would not be a panacea, since Northeast China also has its own

internally-generated problems of lagging economic reform, bankrupt state-owned enterprises and widespread corruption.

¶14. (C) Gao Jingzhu of Yanbian University noted that, as a factual matter, Chinese investment in North Korea to date remains quite small. While there is some investment in minerals extraction, larger state-owned firms seem disinterested in investing in the DPRK. The Chinese government has also done little to encourage such investments, Gao said. He explained that although official export credits are available for trade with North Korea, both official and unofficial Chinese bankers are skeptical of lending to North Korea ventures, given the poor track record of past failures. Ga added that the Tumen River Basin Development Project, despite its recent nominal extension, remains basically dead-on-arrival.

WHY DID KIM JONG-IL VISIT CHINA?

¶15. (C) In a parallel presentation, Li Dunqiu also relayed his conclusions about Kim Jong-il's nine-day, January 2006 visit to China. First, Li said, the visit reflected strong desire to improve relations with China, as evidenced by the fact that Kim brought along such a large cohort of DPRK officialdom. Second, Kim's visit signaled a clear desire to learn about the "China model" for transition and development. Li saw signs of hope that -- unlike Kim's January 2001 visit when he looked only at China's largest cities and companies, perhaps without much comprehension of what he was looking at and how it was achieved -- on this visit Kim toured smaller cities and research institutes focused on more appropriate (less sophisticated) technologies, including agricultural industries.

¶16. (C) Ren Xiao of the Shanghai Institute for International Studies concurred with Li, saying that analysts should not underestimate the importance of the Kim visit. Several

Chinese participants were in fact visibly excited by the possibilities generated by Kim Jong-il's China tour, which took place at the same time as the NBR conference. Marcus Noland cast doubt on the impact of the visit, however, noting that it is impossible to tell what Kim Jong-il actually sees when he looks at China. The January 2001 visit to Shanghai seemed to only generate a desire to have similar tall buildings in Pyongyang, Noland said.

CONVERSELY, HOW BAD IS A NEGATIVE SCENARIO?

¶17. (SBU) Noland followed with a paper outlining the likely negative economic costs for Japan, South Korea and China of a North Korean "nuclear breakout," defined as testing a nuclear weapon or transferring nuclear materials or technology to another country or non-state entity. Noland concluded that while the trade impact of such an event would be small, given the small size of the North Korean economy, the impact on regional financial markets could be considerable. In the worst case, South Korea could experience capital flight and significantly higher overseas borrowing costs, while China could see a worsening of U.S.-China economic relations. The impact on Japan would likely be more temporary, although also tangible.

¶18. (C) In response, Chinese and ROK participants in the meeting generally found fault with Noland's conclusions, calling them exaggerated. The South Koreans questioned how lasting an impact a "nuclear breakout" would have on Seoul financial markets, while Ding Yifan of the State Council Development Research Center opined that U.S.-China and Japan-China ties could certainly weather the storm as well. The top Chinese concern seemed to be the possibility of Japan "going nuclear" in response to a North Korean "nuclear breakout." Noland retorted that these conclusions only underscored his pessimism about the prospects for a North Korean "bold switchover" -- not only are the incentives to change smaller than portrayed (witness the discussion of World Bank aid), but the disincentives for "bad behavior" on

the part of North Korea are also not perceived to be all that large.

WRAPPING UP

¶19. (SBU) Alexandre Mansourov of the Asia Pacific Center for Security Studies gave the final presentation of the conference. Mansourov concluded that many of the building blocks for an economic resurgence are being established in North Korea, including investment in livestock and other agri-businesses, growing trade with China and the ROK (including all-important fertilizer inputs from South Korea), and investment in "sweatshops" and other light industry infrastructure. Mansourov did not perceive the "military first" policy as a fatal impediment to economic reforms in the DPRK, at least on the scale currently envisioned by planners in the North. He also saw purely economic reforms as less risky for the North Korean regime than either tinkering with the "military first" policy or pursuing de-nuclearization via the Six Party Talks.

¶20. (C) In short, calling into question the premise that a "bold switchover" would be needed for North Korea to pursue meaningful and effective economic reform, Mansourov presented changes in North Korea's security stance and economic reform as occurring along independent axes. He predicted that the North will gravitate toward a quadrant that maximizes economic policy change and minimizes changes in the DPRK's security stance. The North will do this, he said, in full knowledge that it will preclude economic cooperation and aid from the United States, Japan or the IFI's, because it is confident that it will still be able to enjoy the benefits of deepening economic relations with China and South Korea. Chinese participants in the conference did not find fault with Mansourov's analysis.

¶21. (SBU) Finally, turning to the role of Russia, Mansourov was dismissive. He called the trans-Korea gas pipeline, trans-Korea railroad and Russian investment in North Korean small enterprises the "three myths" of Russian economic engagement with North Korea. In each case, Mansourov said, the cost is too high and potential benefits too low to attract concerted Russian interest. Mansourov did note, however, that the Kremlin has historically been flexible about using debt forgiveness as a form of assistance, in the right circumstances. For example, Russia has forgiven large debts owed by Iraq, Afghanistan, Syria and Mongolia, for mainly political reasons. North Korea has considerable unpaid official debt incurred with the former Soviet Union.

VERSHBOW